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system puts a lot of pressure on source rules. Territorial systems also strengthen the incentive to locate activities abroad. Finally, a revenue-neutral adoption of a territorial system would require higher taxes on domestic investment to offset lower taxes on foreign income; this, too, is an important consideration in determining if a territorial system is wise policy. Thus, one might legitimately wonder whether such a policy is good for the United States without doubting the important economic contributions of multinational companies.

8. Hufbauer also makes other claims in his analysis that have little backing in the economic research. For instance, he writes:

> Coupling corporate rate reform with a sensible territorial system would unlock a vast pool of earnings now trapped abroad for productive investment and larger consumption in the United States, thereby creating more U.S. jobs.

Yet there is little evidence that tax breaks to encourage repatriation of cash trapped abroad create jobs or investments in the United States. The studies of the repatriation holiday provided by the American Jobs Creation Act of 2004 conclude the opposite: Extra cash was used for dividends and share repurchases, not job creation or new U.S. investment.[6] Also, these ''unrepatriated'' foreign earnings are often already invested in U.S. financial institutions — for example, as bank deposits made available to borrowers.

Hufbauer also argues:

> Moreover, a permanent territorial tax system would indefinitely enlarge U.S. exports by strengthening the competitive position of U.S.-based MNCs in world markets.

This seems particularly strange in light of Hufbauer's earlier claims in his piece that (1) a territorial system would not much affect the relative tax advantage of low-tax countries; and (2) real activity is not very responsive to tax rate differences, as noted in the Grubert study. (The abstract of the Grubert study ends with the observation that ''lower taxes on foreign income do not seem to promote competitiveness.'') If those claims are true, what is the mechanism through which our competitive position in world markets is enhanced?

[6]For a review of the evidence, see Donald J. Marples and Jane G. Gravelle, ''Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis,'' Congressional Research Service R40178 (Oct. 27, 2011), *Doc 2011-22813*, *2011 TNT 210-64*.

Sales Between a Partnership And Non-Partners

By Douglas A. Kahn

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Kahn argues that a 1986 amendment to section 707 invalidated several regulatory provisions promulgated under section 267.

A. Denial of a Loss Deduction

The code denies a deduction for a loss recognized on a sale or exchange between certain related parties. Two of the principal code sections that deny a deduction in that circumstance are sections 267(a)(1) and 707(b)(1)(A). Two regulatory provisions promulgated under section 267 apply the denial of a loss deduction rule to partnerships — reg. section 1.267(b)-1(b) and temp. reg. section 1.267(a)-2T(c), Question 2. I conclude that to the extent reg. section 1.267(b)-1(b) applies to section 267(a)(1), it is invalid and has been invalid since 1986. Also, two of the questions and answers in the temporary regulation are invalid.

1. The operation of section 267(a)(1). Section 267(a)(1) denies a deduction for a loss recognized on a sale or exchange between persons who are related within the terms of section 267(b). In determining whether two persons are related, section 267(c) provides attribution rules treating a taxpayer as owning corporate stock that is actually (or constructively) owned by someone related to the taxpayer. The loss that is denied a deduction by section 267(a)(1) has tax consequence. The transferee (and only that transferee) of the property on which the loss deduction was denied will not recognize a gain on the subsequent disposition of the property[1] to the extent of the deduction denied to the transferor.[2]

Example 1. In year 1, W sold 100 shares of X stock to her daughter, D, for its value of $400. For

[1]If the property that the transferee acquired is exchanged for other property in a nonrecognition exchange, the insulation from income recognition will apply to the exchanged basis property that the transferee acquired in the nonrecognition transaction. Section 267(d)(2).

[2]Section 267(d).

purposes of section 267, W and D are related persons. Section 267(b)(1) and (c)(4). W had a basis of $500 in the 100 shares of X stock. Although W recognized a $100 loss on that sale, none of the loss is deductible because of section 267(a)(1). D's basis in the 100 shares of X is the amount that D paid W for the stock — $400. Three years later, D sold the 100 shares of X stock to an unrelated party for $520. Although D realized a gain of $120 on the sale, only $20 of the gain is recognized. The amount of D's gain that does not exceed the amount of loss W recognized, but could not deduct, on the sale to D is excluded from recognition by D on her sale of the stock.[3]

Example 2. The same facts as those stated in Example 1 except D sold the X stock for $430. Although D realized a gain of $30, she will not recognize any gain. Thus, $30 of the loss W recognized is used to prevent D from recognizing that amount of gain. The additional $70 of loss W recognized but could not deduct will not have tax consequences.

Example 3. The same facts as those in Example 1 except that in year 2, D made a gift of the 100 shares of X stock to her brother, B. B's basis in the stock is $400 — the same as the basis that D had.[4] Several years later, B sold the 100 shares of X stock for $520. B recognized a gain of $120 on that sale. The insulation from gain that section 267(d) provides applies only to the original transferee (D). It does not apply to B.

With one exception, section 267(b) does not include a partnership in describing persons who are related. This article will discuss later whether that provision can apply to partners. Under the one exception, section 267(a)(1) will apply to a sale or exchange between a partnership and a corporation when the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of either a capital interest or a profits interest in the partnership.[5]

2. The operation of section 267(a)(2). Section 267(a)(2) provides that the deduction for expenses or interest owing to a related party who uses the cash receipts and disbursement method of accounting may not be taken before the date on which the related party takes the item into income. This provision seeks to match the date on which the item is deducted with the date it is taken into income by the payee. Section 267(a)(2) does not apply to a loss recognized on a sale or exchange. Instead, that loss may be subject to section 267(a)(1). The list of who constitutes related persons for purposes of section 267(a)(2) is broader than the list provided for section 267(a)(1).[6] For example, unlike subsection (a)(1), subsection (a)(2) applies to an expense or interest payable between a partnership and any person who owns, directly or indirectly, any interest in the capital or profits of the partnership.[7]

3. The operation of section 707(b)(1). Section 707(b)(1) denies a deduction for a loss recognized on a sale or exchange between a partnership and a person owning more than a 50 percent interest in the capital or profits of the partnership. In those cases, the parties who recognized a loss (the partnership, the person owning the requisite interest in the partnership, or both) will be denied the deduction. In determining whether a person owns more than a 50 percent capital or profits interest in the partnership, the person is deemed to own the capital and profits interests held by certain related parties. Section 707(b)(3) adopts most of the constructive ownership of stock rules contained in section 267(c) and applies them to capital and profits partnership interests instead of to corporate stock. If the immediate transferee later disposes of the property for which a loss deduction was disallowed under section 707(b)(1), the transferee may exclude from income an amount of gain up to the amount of loss deduction that was denied.[8]

Example 4. John, Helen, and Katherine are equal partners of the JHK partnership. Helen and Katherine are sisters, and John is not related to either of them. Katherine sells Land No. 1 to JHK for $30,000 cash. Katherine's basis in Land No. 1 is $45,000, so Katherine recognized a loss of $15,000 on the sale. Katherine owns a 33.3 percent interest in the capital and profits of JHK. And, because of the attribution rules of sections 707(b)(3) and 267(c)(2) and (c)(4), Katherine is deemed to own the 33.3 percent capital and profits interest in JHK that her sister, Helen, owns. Consequently, after applying the attribution rules, Katherine owns more than 50 percent of the capital and profits of JHK, so Katherine cannot deduct the $15,000 loss she recognized. If JHK subsequently disposes of Land No. 1 and recognizes a gain on the disposition, an amount of its gain no greater than $15,000 will be excluded from its income.

B. The Two Applicable Regs Under Section 267

Before explaining why I have concluded that portions of the two regulatory provisions under

[3]Section 267(d).
[4]Section 1015(a).
[5]Section 267(b)(10).
[6]*See* section 267(e).
[7]Section 267(e)(1)(A) and (e)(1)(B)(i).
[8]Section 707(b)(1) (penultimate sentence) adopts the provisions of section 267(d), which is described above.

section 267 that apply to partnerships are invalid, I will briefly describe how each operates.

1. Reg. section 1.267(b)-1(b). Reg. section 1.267(b)-1(b) was promulgated in 1958; for convenience, I will sometimes refer to it as the ''1958 regulation.'' The 1958 regulation begins by acknowledging that section 267 does not apply to a transaction between a partnership and a partner, and goes on to say that ''such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners.''

The 1958 regulation then states that a transaction between a partnership and a person who is not a partner is divided into segments and treated as occurring between the non-partner and each of the members of the partnership. For that purpose, the partnership is not treated as an entity, but rather as a fictional representative of the aggregate of the separate interests of its members. The transaction is divided into segments so that in a sale or exchange each partner is deemed to have exchanged a portion of the partnership's property for a portion of the property received in exchange. If a partner is related to the other party within the scope of section 267(a)(1), that subsection will apply to deny a deduction for a loss recognized on the portion of the exchange or sale that is attributed to the related parties. The following examples illustrate how this provision operates. The transactions in these examples took place before 1986.

Example 5. Ralph has a 40 percent interest in the RLNA partnership. Louise has a 35 percent interest. Nathan has a 15 percent interest, and Alice has a 10 percent interest. Nathan and Alice are married and have an adult son, Fred. Fred is not related to Ralph or Louise. Fred sells Land No. 1 to the RLNA partnership for $50,000 cash. Fred's basis in Land No. 1 is $80,000, so Fred recognized a loss of $30,000 on the sale. Under reg. section 1.267(b)-1(b), the transaction is treated as if Fred sold 40 percent of the land to Ralph, 35 percent to Louise, 15 percent to Nathan, and 10 percent to Alice. The losses recognized by Fred on the portions of the sale treated as having been made to Nathan and Alice are not deductible under section 267(a)(1) because Fred is related to them. Consequently, of the $30,000 loss that Fred recognized, he can deduct only $22,500. The $4,500 loss on the portion of the sale to Nathan (15 percent of $30,000) is not deductible, nor is the $3,000 loss on the portion of the sale deemed to have been made to Alice (10 percent of $30,000).

Example 6. The same facts as those in Example 5 except that the RLNA partnership sold Land No. 2 to Fred for $22,000 cash. The partnership had a basis of $62,000 in Land No. 2, so the partnership recognized a loss of $40,000 on the sale. The sale is broken into segments so that each partner is deemed to have sold a portion of Land No. 2 to Fred. Nathan is deemed to have sold 15 percent of Land No. 2 to Fred, so the $6,000 of loss recognized on that portion of the sale is not deductible under section 267(a)(1). Similarly, the $4,000 of loss recognized on the 10 percent portion of the sale deemed made by Alice to Fred is not deductible. The partnership can deduct only $30,000 of the $40,000 loss it recognized.

The 1958 regulation applies the same segmented treatment to transactions (obligations to pay expenses or interest to a related cash-method person) that fall within section 267(a)(2). I do not contend that the portion of the 1958 regulation that applies to section 267(a)(2) is invalid (although it might be). I contend only that the portion that applies to section 267(a)(1) is invalid. In other words, since 1986, the 1958 regulation does not apply to deny a deduction for losses recognized on a sale or exchange between a partnership and a non-partner.

In its 1982 decision in *Casel v. Commissioner*,[9] the Tax Court sustained the validity of reg. section 1.267(b)-1(b). The court approved of the regulation's treating a partnership, for this purpose, as an aggregate of interests rather than as a separate entity. Although the regulation's application to section 267(a)(2) was at issue in *Casel*, the decision would have applied equally to the regulation's application to section 267(a)(1). However, the Tax Court decided *Casel* four years before the 1986 amendments were adopted that I contend invalidated the regulation's application to section 267(a)(1).

2. The temporary regulation. Reg. section 1.267(a)-2T(c), Question 2 applies to a sale or exchange of property between two partnerships in which either the same person has a profits or capital interest in both partnerships or a person who has a profits or capital interest in one partnership is related to a person who has a capital or profits interest in the other partnership. The temporary regulation segments the transaction so the sale or exchange is deemed to take place between one partnership as an entity and the members of the other partnership in proportion to their partnership interests. Once the sale or exchange is characterized as having taken place between a partnership and the members of the other partnership, reg. section 1.267(b)-1(b) applies to deny a deduction for a portion of the loss recognized. One difference between the application of the temporary regulation and reg. section 1.267(b)-1(b) is that the temporary regulation will deny a portion of the recognized loss when the

[9] 79 T.C. 424 (1982).

same person is a member of both partnerships and the 1958 regulation applies only to related persons.

But which partnership is to be treated as an entity and which is to be treated as an aggregate of its members' interests? The temporary regulation provides that the choice is to be made by applying whichever option denies the largest amount of loss deduction. There is a de minimis exception: If the amount to be disallowed as a deduction is less than 5 percent of the recognized loss, the provision does not apply.

Question 3 of the temporary regulation applies similar treatment to expenses and interest payable between two partnerships that have a common partner or have related persons as partners. Question 3 applies section 267(a)(2) in that circumstance. This provision also contains a de minimis exception.

The temporary regulation was promulgated in 1984, two years before the adoption of the 1986 amendments that invalidated questions 2 and 3.

C. Invalidity of the Two Regulations

Section 1812(c) of the Tax Reform Act of 1986[10] amended section 707(b)(1)(A), which had applied to a loss recognized on a sale or exchange between a partnership and a partner who owned more than a 50 percent interest in the profits or capital of the partnership. Section 707(b)(1)(A) was construed to apply only to sales to an actual partner of the partnership. It did not apply to a sale or exchange between the partnership and a person who had no actual ownership of a partnership interest even when that person had a constructive ownership of a partnership interest under the attribution rules of section 707(b)(3). When a person had only constructive ownership of a partnership interest because of the attribution rules, that person was not deemed to be a partner. The 1986 amendment changed the word ''partner'' in section 707(b)(1) to ''person,'' making the provision applicable to a sale or exchange between a partnership and any person who had actual or constructive ownership of a more than 50 percent interest in the capital or profits of the partnership. The Senate report to TRA 1986 states that the amendment means that ''the provisions of section 707(b)(1)(A) and 707(b)(2)(A) will apply whether or not the person constructively holding a 50-percent partnership interest was himself a partner.''[11]

Reg. section 1.267(b)-1(b) applies to a sale or exchange between a partnership and a person who is not an actual partner of the partnership (a nonpartner). The regulation expressly states that it does not apply to a sale or exchange between a partnership and a person who is a partner and that those transactions are ''governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners.'' Consider the following two examples, the events of which occurred before 1986.

Example 7. A, B, and C are partners of the ABC partnership. A has a 70 percent interest in the capital and profits of the partnership. B has a 20 percent interest, and C has a 10 percent interest. B is the parent of C. A is not related to the other two partners. B sells Land No. 1 to the partnership for $70,000 cash. B had a basis of $90,000 in the land and recognized a $20,000 loss. If the ABC partnership were not treated as an entity, 20 percent of the sale would be deemed to have been made by B to himself. Although section 267 does not apply to a sale to oneself, it would seem that such a transaction would not be regarded as a sale at all, and no loss would be recognized on that portion of the transaction. The 10 percent of the sale attributable to C would be between related persons, so 10 percent of B's loss ($2,000) would not be deductible under section 267(a)(1). However, the ABC partnership is treated as an entity because reg. section 1.267(b)-1(b) does not apply to a sale between a partnership and a partner. Accordingly, the only provision that can disallow a loss deduction on this transaction is section 707(b)(1), which does not apply because B does not have a more than 50 percent interest in ABC. B owns outright a 20 percent interest in ABC, and B also owns by attribution the 10 percent interest that C owns. After applying the attribution rules, B's total interest is 30 percent, which is not enough to apply section 707(b)(1). Consequently, B is allowed to deduct the entire $20,000 loss that he recognized.

Example 8. The same facts as those in Example 7 except that F sold Land No. 2 to the ABC partnership for $100,000 cash. F had a basis of $150,000 in Land No. 2, so F recognized a loss of $50,000. F is the brother of B. F and B are related persons for purposes of section 267(a)(1), but F and C are not related persons for purposes of that provision.[12] Because F is not an actual partner of ABC, reg. section 1.267(b)-1(b) applies, and the partnership is not treated as an entity. Twenty percent of the sale is deemed made by F to his brother, B, and section 267(a)(1) will disallow a deduction for 20 percent of the loss recognized by F on the sale (20 percent x $50,000 = $10,000). F will be allowed to deduct only $40,000 of the $50,000 loss that he recognized.

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[10] P.L. 99-514 (1986).

[11] S. Rep. No. 99-313, at 960 (1986).

[12] Section 267(b)(1) and (c)(4).

It seems anomalous that reg. section 1.267(b)-1(b) does not apply in Example 7 but applies to the situation in Example 8. How can that difference be explained? The answer is evident in the language of the regulation itself. When the regulation was promulgated (1958), section 707(b)(1)(A) applied only to a sale or exchange between a partnership and an actual partner of the partnership, and not to a transaction between the partnership and a nonpartner. Treasury considered the treatment of sales between a partnership and a partner of the partnership to be the exclusive province of section 707(b)(1)(A). In other words, the treatment of these transactions was preempted by section 707. Section 707 treats the partnership as an entity for that purpose, and so Treasury concluded that it did not have authority to treat the partnership as an aggregate of interests in that circumstance. Therefore, if after applying attribution rules the partner involved in the transaction does not have more than a 50 percent interest in the partnership, no loss will be denied on the transaction.

However, because section 707(b)(1)(A) did not apply to a transaction between the partnership and a non-partner, Treasury concluded that it was not precluded from treating the partnership as an aggregate of interests and applying section 267(a)(1) to portions of the transaction.

The landscape changed dramatically in 1986 when Congress amended section 707(b)(1)(A) to make it applicable to sales or exchanges between the partnership and non-partners as well as partners. As a result, partnership transactions with non-partners were no longer omitted from section 707. Just as Treasury had been precluded from applying an aggregate approach to a transaction with a partner because of the subject matter coverage of section 707(b)(1)(A), after the 1986 amendment Treasury was precluded from applying an aggregate approach to a sale or exchange between a partnership and a non-partner because of the expanded coverage of section 707(b)(1)(A). Consequently, the portion of reg. section 1.267(b)-1(b) that applies to section 267(a)(1) (that is, to sales or exchanges between a partnership and a nonpartner) is invalid and has been invalid since 1986.

Chevron deference[13] is not applicable to this situation. The 1958 regulation was entitled to deference before section 707 was amended. Because the consequence of the adoption of the 1986 amendment obviously was not before Treasury when it drafted the 1958 regulation, that regulation does not foreclose a determination that the 1986 amendment made section 707 the exclusive provision for denying a loss on a sale or exchange between a partnership and a non-partner.[14]

There is another indication that the 1986 amendment replaced the 1958 regulation. TRA 1986 made several other amendments to section 707, including adding the last sentence of section 707(b)(1). That sentence provides that for purposes of section 267(a)(2), the list of related persons will include two partnerships in which the same persons own (directly or indirectly) more than 50 percent of the capital or profits interest. The Senate report to the 1986 act states that that amendment ''is intended to replace the rule in the Treasury regulations which was suggested by the 1984 Committee Reports.''[15] The footnote to that statement identifies the regulation that was replaced as reg. section 1.267(a)-2T(c), questions 2 and 3. It seems then that that portion of the temporary regulation is no longer valid. But, by referring to Question 2 as well as to Question 3, the Senate report implies that the portion of reg. section 1.267(b)-1(b) that applies to section 267(a)(1) also was replaced. The 1986 amendment adding the last sentence to section 707(b)(1) applies only to section 267(a)(2). Although Question 3 of the temporary regulation applies to section 267(a)(2), Question 2 of that temporary regulation applies only to section 267(a)(1). The provision in Question 2 to treat one of the two partnerships as an aggregate can invoke section 267(a)(1) only by applying reg. section 1.267(b)-1(b) to the members of the partnership treated as an aggregate of interests. Consequently, when the Senate report stated that Question 2 of the temporary regulation was replaced, it could not have been referring to the addition of the last sentence to section 707(b)(1) as the replacing amendment. Because the reference to Question 2 is to a provision that applied to section 267(a)(1) and implicitly to the 1958 regulation, it is reasonable to conclude that the Senate committee considered the 1986 amendments to have replaced that portion of the 1958 regulation.

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[13]''*Chevron* deference'' refers to the position adopted by the Supreme Court in *Chevron U.S.A. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984), concerning the standard to be employed in determining the validity of a regulation. The Supreme Court established a two-pronged test for making that determination. If the intent of Congress is clear, the courts should follow that intent. If the intent of Congress is not clear (if

(Footnote continued in next column.)

the statute is silent or ambiguous), the regulation will be sustained as long as it represents a permissible construction of the statute.

[14]The exception in which section 267(a)(1) can apply occurs if the non-partner is a corporation described in section 267(b)(10) (*i.e.*, when the same persons own more than 50 percent in value of the corporation's stock and more than 50 percent of either a capital or profits interest in the partnership).

[15]S. Rep. No. 99-313, *supra* note 11.

D. Treatment by the Principal Treatises

It is interesting to note how the two most prominent treatises on partnership taxation have dealt with the question discussed in this article.

The McKee, Nelson, and Whitmire treatise deems reg. section 1.267(b)-1(b) to be valid.[16] The treatise notes that if the non-partner constructively owns more than 50 percent of a capital or profits interest in the partnership, section 707(b)(1) will apply to disallow a deduction for all of the recognized loss. However, if the non-partner constructively owns 50 percent or less of the interests in the partnership, the 1958 regulation will apply and section 267(a)(1) will disallow a portion of the recognized loss. The treatise does not discuss the question whether the 1986 amendment replaced the 1958 regulation.

The McKee, Nelson, and Whitmire treatise does state that the 1986 amendment replaces reg. section 1.267(a)-2T(c), questions 2 and 3.[17]

The Willis and Postlewaite treatise[18] also treats the 1958 regulation as valid. However, in footnote 165, the treatise notes that the expansion of section 707(b)(1) to apply to transactions with non-partners raises a question whether the 1958 regulation is still valid. The footnote concludes that the regulation ''still may apply.''

The Willis and Postlewaite treatise treats temp. reg. section 1.267(a)-2T(c) as valid and does not discuss whether the 1986 amendments have replaced some of that provision.[19] Nor does the treatise mention the legislative history to TRA 1986 that states the amendment does replace questions 2 and 3 of that temporary regulation.[20]

E. Conclusion

Contrary to the views of the two principal treatises in this area, I conclude that the portion of the 1958 regulation that applies to section 267(a)(1) has been replaced by the 1986 amendment to section 707(b)(1)(A) and is invalid. The case for the position that that portion of the 1958 regulation is invalid is strong. I agree with the McKee, Nelson, and Whitmire treatise that the 1986 amendment replaced questions 2 and 3 of the 1984 temporary regulation. That view is explicitly supported by the legislative history to TRA 1986.

[16]William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 14.04[3] (2007).

[17]*Id.*

[18]Arthur Willis and Philip Postlewaite, *Partnership Taxation*, para. 11.04[2] (2012).

[19]*Id.*

[20]S. Rep. No. 99-313, *supra* note 11.

Federal Tax Rules Should Not Be Used to Limit Trust Duration

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The federal generation-skipping transfer exemption encourages perpetual trusts, and the federal government can legitimately end that incentive. However, the authors believe that professor Lawrence W. Waggoner's proposed solution would be an inappropriate use of federal tax law because it would impose a tax penalty on perpetual trusts, rather than merely eliminating the existing tax incentive to create them.

Professor Lawrence Waggoner's recent article titled ''Effectively Curbing the GST Exemption for Perpetual Trusts'' raises practical and policy problems with the existence of perpetual trusts and indicates that the enactment of the generation-skipping transfer tax (GSTT) is responsible for encouraging several states to repeal their limits on perpetual trusts.[1] We admire and respect Waggoner and acknowledge that the concerns he raises may be perfectly valid. We also agree that federal tax policy in the form of the GST exemption encouraged perpetual trusts and that the federal government can legitimately end that incentive.

However, we strongly disagree with Waggoner's solution because it is intended to, and would, impose a tax penalty on perpetual trusts rather than

[1]*Tax Notes*, June 4, 2012, p. 1267, *Doc 2012-9442*, *2012 TNT 110-14*. The GSTT was enacted as part of the Tax Reform Act of 1986. It allowed each taxpayer to allocate his GST exemption to donative transfers during life or at death. Each taxpayer originally had a GST exemption of $1 million. Currently, that exemption per donor is $5.12 million, although it is scheduled to return to $1 million, indexed for inflation, at the end of 2012.